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C O N F I D E N T I A L SECTION 01 OF 04 TAIPEI 002336

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SUBJECT: LOOKING AHEAD AT CROSS-STRAIT ECONOMIC POLICY

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Classified By: Robert S. Wang, AIT Acting Director, for reasons 1.4 (b)
and (d).

11. (C) SUMMARY. During recent discussions of future cross-strait economic policy with AIT economic chief, Mainland Affairs Council Chairman Chen Min-tong and prominent private analysts all predicted eventual progress on establishing direct passenger flights, easing investment restrictions, and increasing the number of Mainland tourists in Taiwan, regardless of who wins the March presidential election. Analyst Daniel Liu, however, cautioned that technology transfer and investment have supplanted direct transportation links as a top Chinese priority. Chen, an advisor to DPP presidential candidate Frank Hsieh, advocated cross-strait financial sector liberalization, including the possibility of allowing Chinese banks to use representative agents in Taiwan. END SUMMARY.

12. (SBU) Chen Min-tong is Chairman of the Mainland Affairs Council (MAC), a Cabinet-level official agency, and advises DPP presidential candidate Frank Hsieh on cross-strait economic policy. Daniel Liu (Liu Da-nien) is International Division Research fellow at the Chung-Hua Institution for Economic Research (CIER), a Blue-leaning think tank supported by both official and private funds. David Hong (Hong De-sheng) is president of the Green-leaning Taiwan Institute of Economic Research (TIER), a private think tank.

Current status of cross-strait economic relations

13. (C) According to Hong, starting in the early 1990s, Taiwan investment in China focused on labor-intensive manufacturing.

This investment helped China develop its own labor-intensive industrial sector, he noted. Since 2000, however, Taiwan's investment has shifted into high technology, with some accompanying technology and managerial transfer. Liu observed that China now accounts for over half of Taiwan's overseas investment, and that sales to China are the largest contributing factor to Taiwan's trade surplus. Taiwan companies increasingly treat China as a "home market," he

observed. In recent years, he continued, Taiwan investors have shifted from seeing the Mainland as a "world factory," and now view it as a market.

14. (C) In Liu's analysis, Taiwan and South Korean investors are following different Mainland strategies: Korean companies are first building brand awareness and then exploiting the market, while Taiwan firms continue to focus on original equipment manufacturing (OEM), and are relatively weak in branding. According to Liu, Taiwan's most successful Mainland investors are able to exploit China's cost advantages while retaining higher value-added functions in Taiwan. Giant, for example, makes low-end bicycles on the Mainland, but continues to manufacture its high-end products in Taiwan. Other firms, however, have almost entirely abandoned Taiwan for China. Liu cited anecdotal evidence that some investors have returned to Taiwan due to rising labor costs in China. A Shanghai-area university graduate, for example, earns nearly as much as a Taiwan counterpart, but is perceived to be less qualified and efficient. As a result, said Liu, some Taiwan firms have shifted employment back home. (Note: We also have anecdotal reports that Taiwan firms have repatriated some work from the Mainland due to Taiwan's stronger IPR protection regime.)

Facts and figures

15. (SBU) Hong said that there are between 800,000 and 1 million Taiwan residents now living on the Mainland. In the early 1990s, small business owners and their employees dominated the Taiwan presence, but in recent years the profile has shifted in favor of young college graduates. According to Liu, roughly 1 million Taiwan residents now live in China. Further, he said, a large number, perhaps up to an additional 1 million, use China as their main residence, but

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return temporarily to Taiwan every several months. Liu noted that recent years have seen a relatively higher percentage of young, well-educated Taiwan residents move to the Mainland. A growing number of entire families are moving across the Strait, he added, rather than just single workers. MAC Chairman Chen estimated the number of Taiwan residents in China at 1 million. (Note: The Taiwan authorities do not appear to have a firm count of the number of Taiwan residents who have moved to China, perhaps because some maintain residences in both places. 1 million is the most commonly-used figure.)

16. (SBU) Taiwan statistics put cumulative Taiwan investment in China at USD 59.729 billion, a figure Liu says should be seen as a "floor," since it does not include investment made via international tax havens, or made by Taiwan's small- and medium-sized enterprises (SMEs). The corresponding PRC figure on Taiwan investment in the Mainland is over USD 100 billion, and Liu estimated that the actual figure is probably at least USD 120 billion. Chen put Taiwan's actual investment total at about USD 150 billion.

17. (SBU) Regarding fund repatriation by Taiwan investors on the Mainland, Hong said Taiwan investors in China typically repatriate funds via Hong Kong or other third country channels. Although these channels are quite open, he explained, Taiwan's double taxation and inheritance taxation regulations result in a "very small" level of actual fund repatriation. Citing Ministry of Economic Affairs statistics for 2005, Hong noted that 41.28 percent of Taiwan company profits are kept in China as capital reserves, while 24.56 percent was reinvested on the Mainland and only 3.45 percent was reinvested in Taiwan. Larger companies (i.e., those traded on the stock exchange in Taipei) reinvested about 7-8 percent in Taiwan, he noted. Hong added that about 20 percent of Taiwan firms on the Mainland did not record any profit in 2005.

Cross-Strait policy priorities

¶8. (C) Chen, who advises DPP presidential candidate Frank Hsieh on cross-Strait economic policy, said that a Hsieh administration would combine continuity with existing DPP policy and "new vision" from Hsieh. Although cautioning that China "always uses economic means to achieve political purposes," Chen stated that a Hsieh administration would combine "pro-active liberalization" and "effective management" of the cross-Strait economic relationship. (Note: This contrasts with the current more cautious policy of "active management and effective liberalization.") According to Chen, the PRC has stymied progress on cross-Strait economic integration for fear that Chen Shui-bian will garner the credit. If Hsieh wins the presidential election, however, "China will have to compromise with Taiwan and figure out a policy to move things forward."

¶9. (C) Each of our interlocutors identified direct transportation links, revision of investment restrictions, and tourism as the top priorities for cross-Strait economic liberalization. Hong stressed that certainty on transportation policy may actually be more important than the content of the policy itself, as Taiwan businesses must be able to make plans based on clear policy expectations. Regardless of who wins the presidential election, Liu does not expect fast action on establishing direct links due to the issue's extreme political sensitivity. In his analysis, progress on direct transportation links is no longer a top priority for China, which he believes is now focused on encouraging Taiwan investment and technology transfer. Chen emphasized the importance of establishing direct passenger flights, and said that using the current cross-Strait charter format could initially be used to avoid the political complications inherent in signing a formal agreement with China on establishing regular cross-Strait flights. Within a year of expanded charter flights, he predicted, regular

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passenger service could be formally realized.

¶10. (C) On investment limits, Hong argued that the current investment cap of 40 percent of a company's net worth should be lifted, although he added that relatively few Taiwan companies are subject to the limit in practice. He advocated a flexible, case-by-case approach to investment ceilings, rather than a blanket ceiling. Liu predicted an easing of investment restrictions after Chen Shui-bian leaves office, especially in the financial sector, as Taiwan investors are increasingly demanding help in facilitating RMB transactions.

In Hong's analysis, the ball is primarily in China's court to facilitate Taiwan investment in the Mainland financial sector. Both sides need to work out daily settlement mechanisms, but the Chinese, he asserted, "don't want to sit down with us to talk."

¶11. (C) Chairman Chen was generally supportive of a more permissive cross-Strait investment regime, but expressed concern about job loss in Taiwan's manufacturing sector, as well as the ramifications of China's drive to move up the technology ladder. Intel's investment in Dalian, he observed, is "giving us a lot of pressure." In his view, China's expansion into high-technology will place increasing competitive pressure on both Taiwan and the U.S. According to Chen, provided the reform does not threaten Taiwan's sovereignty, Frank Hsieh would probably consider allowing an "incremental opening" to Chinese investment in Taiwan, although it is not clear which sectors would be affected. Chen supported liberalizing cross-Strait banking exchanges, possibly to include mechanisms for Chinese banks to use representative agents in Taiwan, as well as allowing use of the RMB here.

¶12. (C) Hong supported increased tourism from the Mainland,

but added that a ceiling should be set on annual arrivals. Otherwise, he argued, Chinese tourists could "overwhelm Taiwan identity." Liu predicted a relaxation of restrictions on Mainland tourists, no matter who wins the election. Chairman Chen supported an eventual increase in the quota of Chinese tourists to 3,000 per day.

¶13. (C) COMMENT. Despite variations in emphasis and analysis, these conversations reveal a significant consensus on the priorities for cross-Street economic liberalization. Regardless of who wins the presidential election, increased economic integration across the Taiwan Strait will not be a question of if, but rather how, and at what pace. END COMMENT.

Biographic data

¶14. (C) Chen Min-tong was born in Taichung on November 25, 1955. One of his parents is aboriginal. He holds bachelor's master's, and doctoral degrees in political science from National Taiwan University (NTU), and conducted post-doctoral East Asian studies at Columbia University in 1991. Chen has held various research fellowships at NTU, and from 1996 has been a professor at NTU's Institute of National Development. In 2000-2004, he served as Vice Chairman of the Mainland Affairs Council, and assumed his present position as President in April 2007. Chen and his wife, who works for the Bank of Taiwan, have two children. Chen speaks moderately fluent English.

¶15. (SBU) David Hong (Hong De-sheng) appears to be in his 60s. Originally from Changhua, he holds a bachelor's degree in economics from National Taiwan University, a master's degree in economics from Vanderbilt University, and a doctorate in economics from the University of Minnesota. In 1981-84, he was economic service manager at the Minnesota Department of Public Service. From 1985 through 1993, Hong held various positions with Northern States Power Company in Minneapolis. In 1989-90, he was also an adjunct economics professor at St. Thomas College in Minneapolis. After returning to Taiwan in 1994, Hong was Director of the Taipei City Finance Department, and has since held various positions

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at the Taiwan Institute of Economic Research. Hong speaks fluent English.

¶16. (SBU) Daniel Liu (Liu Da-nien) appears to be in his 40s. A Taipei native, his parents are from the Mainland, and his father came to Taiwan in 1949 with the Nationalist army. He received his doctorate from Cornell University, where he studied in 1985-90. Liu speaks fluent English.
WANG